84-SBE-090

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HINSHAW'S DEPARTMENT STORES, INC.)

Appearances:

For Appellant:' Richard M. Wolf
Certified Public Accountant

For Respondent: Jon Jensen
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Hinshaw's Department Stores, Inc., against a proposed assessment of additional franchise tax in the amount of $53,152 for the income year ended July 31, 1977.

The issue presented in this appeal is whether certain advances made by appellant to its wholly owned subsidiary should be characterized as loans or as contributions to capital.

Appellant is a corporation which on February 2, 1971, acquired all the stock of Barron's Emporium Drug Stores, Inc. (hereinafter referred to as "Barron's") for $18,574. Commencing the day after acquisition, appellant began a series of advances to Barron's. The initial advance totalled $150,000. Subsequent advances, usually in the amount of either $25,000 or $50,000, were made as Barron's needed funds. The advances, although unsecured and made without collateral, were in the form of six-month notes and were due on either January 31 or July 31. On these due dates a renewal note was always entered into by the parties which incorporated all advances made up to that due date. All the notes had an interest rate of five percent, with the exception of the initial advance, and upon renewal on August 2, 1971, that interest rate also became five percent. In all, nineteen advances were made which totalled $700,000.

In August of 1976, appellant liquidated Barron's. Upon dissolution, all of Barron's assets were transferred to appellant. The assets, totalling $128,000, were transferred between September 30, 1976, and November 30, 1976. Prior to September, no principal payments were made, although appellant received interest payments from Barron's semiannually.

On November 24, 1980, respondent issued a notice of proposed assessment disallowing the $572,000 claimed bad debt deduction for loans and the $78,574 deduction claimed for worthless securities. The deductions were disallowed as respondent treated the advances as contributions to capital and applied Revenue and Taxation Code section 24502, which provides that gain or loss will not be recognized on the receipt of property distributed in complete liquidation of an 80-percent subsidiary. Appellant, in filing this appeal, contends that the advances were loans and that the deductions were proper.

A corporate taxpayer is entitled to a deduction for debts which become worthless during the income year. (Rev. & Tax. Code, § 24348.) Therefore, if the advances are found to be loans, the $128,000 in payments made between September 30, 1976, and November 30, 1976, were repayment of these loans and were not a distribution of assets in complete liquidation. Hence, the provisions of

Revenue and Taxation Code section 24502 would not apply. If, however, the advances are treated as capital contributions, they become a part of appellant's basis in Barron's stock. When Barron's was liquidated in August of 1976, therefore, the subsequent transfer of assets to appellant totalling $128,000 would be subject to Revenue and Taxation Code section 24502, and no loss could be recognized.

The question of whether a corporate shareholder's advance to its wholly owned subsidiary is a loan or a capital contribution is essentially one of fact on which the taxpayer bears the burden of- proof. *(White v. United States, 305 U.S. 281, 292 [83 L.Ed. 172, 179] (1938).) A capital contribution is intended as an investment placed at the risk of the business, while a loan is intended to create a definite obligation payable in any event. In other words, to qualify for a bad debt deduction, the advance must be made with a reasonable expectation of repayment. (Appeal of George E. Newton, Cal. St. Bd. of Equal., May 12, 1964; Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957), on remand, ¶ 58,008 P-H Memo. T.C. (1958), affd., 262 F.2d 512 (2d Cir.), cert. den., 359 U.S. 1002 [3 L.Ed.2d 1030] (1959).)

Revenue and Taxation Code section 24348, which governs the deductibility of bad debts, is substantially similar to section 166 of the Internal Revenue Code. It is well settled in California that when state statutes are patterned after federal legislation on the same subject, the interpretation and effect given the federal provisions by the federal courts and administrative bodies are relevant in determining the proper construction of the California statutes. (Andrews v. Franchise Tax Board, 275 Cal.App.2d 653, 658 [80 Cal.Rptr. 403] (1969); Appeal of Horace C. and Mary M. Jenkins, Cal. St. Bd. of Equal., April 5, 1983.) The courts, in attempting to deal with the problem of distinguishing a loan from a capital contribution, have isolated certain factors. While no single criterion or series of criteria can provide a conclusive answer (see Newman v. Quinn, 558 F.Supp. 1035, 1039 (D.V.I. 1983)), the following have been considered:

(1) the proportion of advances to equity;

(2) the adequacy of the corporate capital previously invested;

(3) the control the donor has over the corporation;

(4) whether the advance was subordinated- to the rights of other creditors-;

(5) the use to which the funds *were* put; and

(6) whether outside investors would make such an advance.

(See United States v. Henderson, 375 F.2d 36, 40 (5th Cir.), cert. den., 389 U.S. 953 [19 L.Ed.2d 362] (1967); Rev. & Tax. Code, § 24580; Int. Rev. Code, § 385.)

Applying the above consideration to the present case; we are convinced that the advances to Barron's were equity investments. When Barron's was purchased for $18,574, its balance sheet indicated' a deficit in retained earnings. There was $60 in cash, inventory of $111,000, net receivables of $36,350, and current liabilities of approximately $173,000. On the day following its purchase, appellant had to advance Barron's $150,000. It is apparent that Barron's needed additional funds to pay various operational expenses. Although an examination of this financial data does not conclusively establish that Barron's was inadequately capitalized, the circumstances do indicate that Barron's was continually in need of cash during the time when all the advances were made. This is evidence that appellant could not have reasonably expected repayment. (Richard B. Thaler, et al., ¶ 78,024 P-H Memo. T.C. (1978).)

The independent-creditor test also provides a useful analytical framework for ascertaining the economic reality of *a* purported debt. In the instant case, the advances were made without either a secured interest or collateral. It appears from the available evidence that the advances made by appellant were not made under conditions comparable to those required by an outside lender. While the advances were in the form of a loan, where a closely held corporation is involved, form does not always correspond to the nature of the transaction because the parties can create whatever appearance may be of tax benefit to them despite the economic reality of the advance-. (Paul L. Dunmire, ¶ 81,372 P-H Memo. T.C. (1981).) Form is not, therefore, the controlling factor. (Midland Distributors, Inc. v. United States, 481 F.2d 730 (5th Cir. 1973).) Although the advances were in the form of interest-bearing notes with fixed due dates, each time one of the so-called notes became due and payable, it was renewed as a routine matter without any specific action against Barron's. Thus, it cannot be said with any sense of reality that the advances were in fact loans. (See Old Dominion Plywood Corp., ¶ 66,135 P-H Memo. T.C. (1966).) With respect to the alleged interest paid, the record discloses that the interest was in all probability paid from funds received from the subsequent advances. In other words, without the subsequent advances, it is doubtful that any interest payments would have been made to appellant.

We must conclude that Barron's was, for all practical purposes, insolvent from the outset. The advances made by appellant were the only practical source to which creditors of Barron's could look for payment of their claims. (See Merlite Industries, Inc., ¶ 75,312 P-H Memo. T.C. (1975).) Barron's records show th-at the other creditors were in fact paid, while appellant was not paid until the corporation was liquidated. Barron's final balance sheet shows only $572,000 in liabilities, which is the amount owed to appellant. ($700,000 in advances minus payments of $128,000.) This is evidence that claims by appellant were subordinated to all outside creditors.

Finally, the identity of interest between Barron's and appellant is of consequence. At the time of the advances, appellant was the controlling shareholder of Barron's. Appellant's ownership of 100 percent of Barron's stock constitutes another indicium of equity. (Paul L. Dunmire, ¶ 81,372 P-H Memo. T.C. (1981).)

Having considered the totality of all the factors discussed above, we must conclude that the funds advanced by appellant to Barron's were placed at the risk of the subsidiary's business success, and therefore represent contributions to capital. There was no reasonable expectation of repayment. Consequently, appellant is not entitled to a bad debt deduction with respect to these funds. Appellant is also not entitled to a worthless stock deduction in this situation. Section 24502 of the Revenue and Taxation Code applies here and provides that no gain or loss shall be recognized on this type of complete liquidation of a subsidiary. Accordingly, we must sustain respondent's action in this matter.

Appeal of Hinshaw's Department Stores, Inc.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Hinshaw's Department Stores, Inc., against a proposed assessment of additional franchise tax in the amount of $53,152 for the income year ended July 31, 1977, be and the same is hereby sustained.

Done at Sacramento, California, this 27th day of June, 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenbury, Mr. Collis and Mr. Bennett present.

Richard Nevins, Chairman

Ernest J. Dronenburg, Jr., Member

William M. Bennett, Member

____________, Member

____________, Member